

FINANCING OPTIONS FOR ENTREPRENEURIAL VENTURES

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Abstract

Entrepreneurship is the practice of starting new organizations or revitalizing mature organizations, particularly new businesses generally in response to identified opportunities. The classic entrepreneurship is the "Start-Up", where a raw idea develops into a high-growth company and the success involves strong main entrepreneur and a team with complimentary talents. Start-ups are the engine for job creation and economic growth. The lifecycle of a new venture includes seed stage, start-up stage, early stage, and later stage. Securing funding for a start-up in its early stages is from internal sources. The funder provides the initial capital, along with funds from family and fiends (3Fs), and the firm also relies on bootstrapping & business alliances. As the firm grows and needs additional capital, it will require external sources of funding: business loan from a bank, government-sponsored programs/grants, professional investors (angel investors, venture capitalists, and corporate investors), initial public offering (IPO) and the equity markets. This article provides an overview of the funding options for start-up ventures with special emphasis on business angels and venture capital.

Keywords: entrepreneurship; start-up venture; innovation; angel investors; venture capital.

JELClassification: L 26, M 13

Introduction

The word "entrepreneur" is a loanword from French, where the verb "entreprendre" means "to undertake". Entrepreneur is a term applied to the type of personality who is willing to take upon her/himself a new venture or enterprise and accepts full responsibility for the outcome. The word *entrepreneur* is often synonymous with *founder*. Most commonly, the term entrepreneur applies to someone who creates value by offering a product or service. Entrepreneurs often have strong beliefs about a market opportunity and organize their resources effectively (land, labor, and capital) to accomplish an outcome that changes existing interactions. Entrepreneurship is truly a global phenomenon, and, coupled with the Internet is flattening and democratizing the world. Entrepreneurs create new technologies, products, processes, and services that become the next wave of new industries.

According to the US Small Business Administration, a "Small Business" is one that has less than 500 employees for most manufacturing and mining industries, and \$7 million in

average annual receipts for most non-manufacturing industries. In 2004, small businesses accounted for 99.9% of the 26.8 million businesses in the US. Entrepreneurship is widely regarded as an integral player in the business culture of American life, and particularly as an engine for job creation and economic growth. Over the past decade small businesses created 60-80% of the net new jobs. In 2004, small firms had a net gain of 1.86 million new jobs, while firms with over 500 employees had a net loss of 180,122 jobs. Since World War II small entrepreneurial firms have been responsible for 50% of all innovation and 95% of all radical innovation in the US.

At the heart of the entrepreneurial process are the creation and/or recognition of opportunities. The classic entrepreneurship is the "Start-Up", where a raw idea develops into a high-growth company and the success involves strong main entrepreneur and a team with complimentary talents. The team has the ability to see opportunity where others see contradiction, and the main entrepreneurs is making sure that the start-up does not run out of money when it needs it most. In the *seed stage* the entrepreneur has a concept for a potentially profitable business opportunity that still has to be developed and proven. In the *start-up stage*, the newly formed business is completing product development and initial marketing. Typically the business is 1 year old or younger. In the *early stage* the firm is usually expanding, and producing and delivering products or services. It is often less than 5 years old and it may not yet be profitable. In the *later stage*, also called the expansion stage, at this level of development the firm is mature and profitable, and often still expanding. With a continued high-growth rate, it may go public within 6 months to a year.

Smaller means higher failure odds. Getting the odds in his/her favor is the entrepreneur's perpetual challenge, and the smaller the business, the poorer are the odds for survival. To beat the odds, a start-up needs to reach 10-20 people and \$2-3 million in revenue. Thinking big enough can improve the odds significantly. Higher potential ventures understand and successfully balance its three driving forces: the opportunity, the team, and the resources.

1. How to Fund a New Venture?

Securing funding for a start-up in its early stages is from *internal sources*. The funder provides the initial capital, along with funds from family and friends (3Fs), and the firm also relies on bootstrapping & business alliances. As the firm grows and needs additional capital, it will require *external sources* of funding: business loan from a bank, government-sponsored programs/grants, professional investors (angel investors, venture capitalists, and corporate investors), initial public offering (IPO) and the equity markets.

The funding available to a start-up depends on its long term potential. There are three types of start-up firms: lifestyle, middle-market, and high-growth potential firms. *Lifestyle firms* provide only a reasonable living for their founders. This is the classic small business and 90% of all start-ups belong to this category. They are unlikely to attract equity funding from outside sources and are primarily funded by internal funds. Their five year revenue projections are under \$10 million. *Middle-market* firms constitute less than 10% of all start-ups. They grow 20% annually and their five year revenue projections are \$10-\$50 million. These firms are attractive to business angels and highly depend on bootstrapping for initial growth. *High-potential firms* are less than 1% of all start-ups. They grow over 50% annually and their five year projections are more than \$50 million. They plan to grow to over 50 employees within 5-10 years and expect multiple rounds of external funding from angels and venture capitalists.

2. Internal Sources of Funding

Founder, Family and Friends (3Fs), include founder's personal savings, as well as funds received from family and friends, also called "love money". The longer the entrepreneur is able to survive on personal funds and hard work (sweat equity) and internally generated funds the lower the cost of external risk capital (surrender less equity to obtain a given amount of funds), and the more sovereignty the entrepreneur has.

Bootstrapping is highly creative acquisition and use of resources without raising capital from traditional sources or borrowing money from a bank. There is a high reliance on: internally generated retained earnings, credit cards, home mortgages, and customer advances. Benefits of bootstrapping are waiting as long as possible to seek equity financing permits getting financing at better terms and retaining more ownership share, greater authority and overall control, the entrepreneur spends time and resources on growing the firm, rather than courting investors, and the entrepreneurs avoids problems associated with raising too much money. Disadvantages of bootstrapping are that it may not generate enough money to grow the firm at the desired rate, the firm competing poorly against its financially endowed competitors, there is limiting potential grasp on sales, market share, and overall competitive position, and it offers only limited support for high-growth prospects.

Business Alliances constitute of forming "cooperative agreements" with another firm to generate revenues and reduce costs. Reasons for forming a business alliance are: market penetrations, accelerate time to market, utilize sales and marketing channels, geographic expansion, access to customer lists, build product credibility, inadequate resources to go alone, customer requests, product development, economies of scale, teaming up vs. competing, gain business experience, joint bidding on projects, and other. Business alliance partners are found by active search based on industry knowledge, professional associations, industry networks and contacts, attorneys, trade shows, accountants, bankers, friends, investment forums, and other. Effective business alliances can be very beneficial to a start-up or early stage firm with inadequate resources to do it alone, but these alliances do not always make sense once the firm has grown, is healthy, and reaches self-sufficiency.

3. External Sources of Funding

Angels are successful business people who invest their own money. The term "angel" comes from the practice in the early 1900's of wealthy businessmen investing in Broadway productions. An angel investor or angel (known as a business angel or informal investor in Europe) is an affluent individual who invests capital into a business start-up, usually in exchange for ownership equity. The "average" private investor is 47 years old. Angels typically invest in technologies or in business in the areas that are known to them. Most angels invest close to home and rarely put in more than a few hundred thousand dollars. They are long term investors and usually expect to receive a return within 5 to 7 years. They seek a return commensurate with the risk, and enjoy advising/assisting the entrepreneurs.

Generally angels fund ventures that have early stage high-risk money required to run a 10 to 20-employee firm and that can grow to a "middle market" company with 50 to 100 employees with an annual sales ranging from \$10 or \$20 million. Angel investors expect an average 26% annual return at the time they invest, and they believe that about one-third of

their investments are likely to result in a substantial capital loss. They invest alone or in angel organizations, and accept an average of 3 deals for every 10 considered. The most common reasons given for rejecting a deal are: insufficient growth potential, overpriced equity, lack of sufficient talent of the management, lack of information about the entrepreneur or key personnel.

Ventures suitable for angel financing are ones with capital requirement of \$50,000 to \$250,000, with sales potential of between \$2 million and \$20 million within 5 to 10 years, small, established, privately held ventures with sales and profit growth of 10% to 20% per year, special situations, such as very early financing of high-technology inventors who have not developed a prototype, and companies that project high levels of free cash flow within 3 to 5 years.

Entrepreneurs can find angels through other entrepreneurs (already funded by angels and/or seeking to invest themselves), organizations (formal matching services, angel alliances, venture capital clubs, internet services, private matchmakers), networks (personal: friends, family, colleagues, etc.), professional: attorney, stockbroker, banker, etc.), and through publications (mailing lists, newspaper leads and ads).

In the United States, the Securities and Exchange Commission Rule 501 of Regulation D states an accredited investor is an individual who has a net worth of more than \$1 million, or an expected individual (household) yearly income of more than \$200,000 (\$300,000 with spouse). The Federal Reserve's Survey of Consumer Finances estimates that over 6 million US household qualify to be accredited investors. Many studies estimate that the number of active angel investors in the US is between 250,000 and 400,000.

Angel investors organize themselves into angel groups or angel networks to share research, due diligence, and pool their investment capital. In 1994 the first angel group was formed in Silicon Valley, called the Band of Angels. In 1996 there were about 10 angel groups, and as of 2008 there are over 250 angel groups. Angel investors organize themselves into angel groups or angel networks to share research, due diligence, and pool their investment capital. Angel investing has become a movement, and angels in the US invest between \$20 and 40 billion annually. The rise of angel networks and angel syndicates enables pooling money to invest in larger deals, diversification across multiple investments, consistent flow of quality deals, leveraging and sharing network of contacts and expertise, ability to conduct deeper and broader due diligence, ability to add more investments to an existing portfolio, ability to add further follow-on rounds to existing investments.

Venture Capitalists (VCs) are financial intermediaries, meaning that they take the investors' capital (not their own) and invest it directly into portfolio companies. A venture capital firm invests only in private companies and they take an active role in monitoring and helping the companies in their portfolio. Their investment is utilized to fund the internal growth of companies and their primary goal is to maximize its financial return by exiting investments through sale or IPO. Venture Capital activities are: investing, monitoring, and exiting.

In 1946, General George Doriot and Ralph Flanders, President of the Federal Reserve Bank of Boston, founded the American Research and Development Corporation (ARD) – the first firm, as opposed to individuals, to provide risk capital for new and rapidly growing firms. In its 25-year existence as a public company, ARD earned annualized returns for its investors of 15.8%. In 1979, VCs invested \$460 million in 375 companies. In 1989, that

number skyrocketed to \$31 billion invested in 1,729 companies. The '80s brought significant structural changes in the VC industry. The average fund size grew larger and larger; mega-funds of more than \$500 million accounted for nearly 80% of all VCs, the average investment size correspondingly grew much larger, as well; \$20 million, \$40 million, even \$80 million rounds during the dot-com times and there was a specialization pattern toward information technology. The peak was reached in 2000 with \$107 billion invested in 5,500 companies. March 2000 was the crash of NASDAQ with 60% drop in value.

Typically VCs fund second round and development capital for later stage firms due to structural reasons: high overhead cost, and high evaluation and monitoring costs relative to the size of the investment, and long payback period and inherently high risks when investing in early stage start-ups. Traditionally VC investments have been concentrated in two broad sectors: Health Care and Informational Technology (IT). Silicon Valley is epicenter of VC activity, with 30% of total VC US investments per year.

Venture capital is most attractive for new companies with limited operating history that are too small to raise capital in the public markets and are too immature to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value). Ventures suitable for VC investment are: new emerging and middle-market private companies that will go public or merge within 4 to 7 years, they have a complete management team with significant competitive advantage, they have \$5 million to \$200 million in sales; with a billion-dollar potential, growing 25% per year, with gross margin 40% to 50% or more, and able to return 10 times of the original investment.

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies, and pooled investment vehicles, called fund of funds or mutual funds.

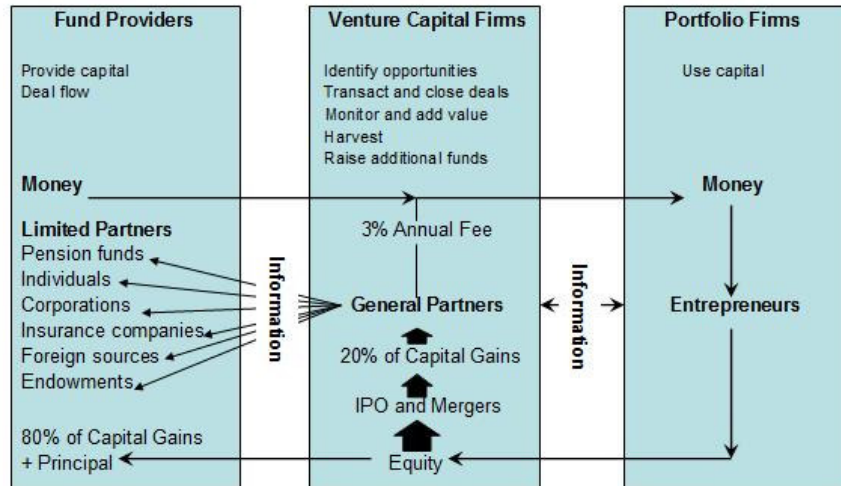


Figure 1 The Flows of Venture Capital¹

Corporate Investors are often seen by small firms as an exit opportunity, rather than a financing source. By acquiring small firms, corporate investors complement their product or service offerings, and small firms use this new influx of strategic funding to further expand operations. An example is Microsoft's acquisition of Hotmail for \$425 million. Corporate venturing prevents the small firms from allying with the competitors or from competing directly with the corporate investor. Many entrepreneurs nowadays are starting ventures with the sole objective of being bought out by a large non-financial corporation.

The Equity Markets are a funding option to only few entrepreneurial firms - the US Small Business Administration estimates that less than one in a thousand new ventures actually have an IPO. Advantages of going public are: attracts further capital that can be used for the company's growth, permits investors who funded the firm to have an exit, and the entrepreneurs are also rewarded for their endeavors. An IPO has to be in the \$20-50 million range to create a market for a firm. 26-33% of all IPOs in the US are VC funded firms. IPOs may not enable investors to immediately sell their stake holdings in an entity due to vesting requirements.

Banks prefer to limit their risk by lending to firms that offer some form of collateral. It is important source of external financing for small firms once they are established and creditworthy. Reasons banks shy-away from early stage firms are: lack a track record of reliable information on the entrepreneurs, start-ups are illiquid, they have too much debt outstanding, they have volatile profit and cash flow measures, and if the placement is successful, the bank makes only 4-6% in interest, but if it loses the money it can lose it all plus attorney's fees.

¹ Source: New Venture Creation: Entrepreneurship for the 21st Century; By: Jeffry A Timmons, Stephen Spinelli; Publisher: McGraw-Hill/Irwin; Eight Edition (September 4, 2008)

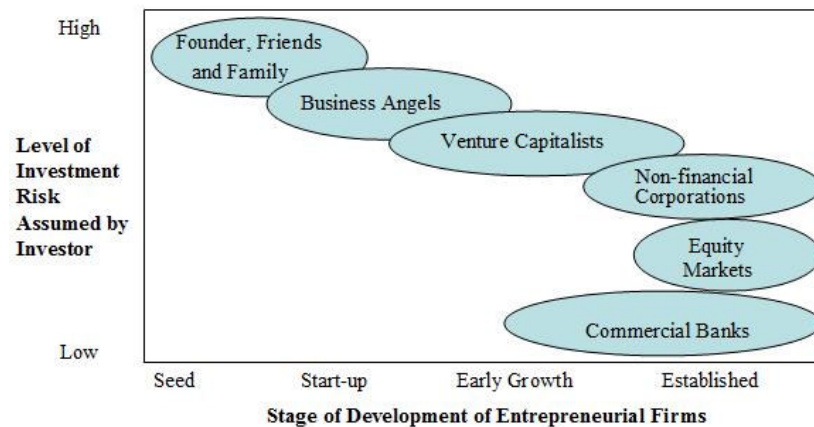


Figure 2 Funding Sources for Entrepreneurial Ventures²

4. Beyond the Funding

The founder and the investors make return on their investment when the venture has a successful exit. There are several harvest options: a “*capital cow*” is a capital rich and cash rich company; *employee stock ownership plan* is when the founders can realize some liquidity by selling some of their stock to the employee plan or to other employees; *management buyout* exists when the founder can realize liquidity by selling it to the other existing partners or to the management of the company; the company can be *merged* with or *acquired* by another company, there can be an *outright sale* for stock exchange and/or cash exchange, and going public, i.e. having an *initial public offering* to provide access to long-term capital.

A majority of highly successful entrepreneurs seem to accept the responsibility to renew and perpetuate the system that has treated them so well. They donate to college endowments and scholarship funds; become involved in community activities; and they invest in new companies, i.e. re-invest in the next generation of entrepreneurs.

Conclusion

Entrepreneurial start-up ventures create jobs, and sustain the economic growth. Understanding the financing options in different stages of the venture’s lifecycle is essential for securing sustainable growth. Entrepreneurs should financially discriminate between investor types, do not take just the first offer, but rather the most appropriate for the firm. On the other side, the risk and failure rates associated with start-up firms are extremely high and investors seek commensurable return. Business economies have an opportunity to create a platform with organized vehicles for funding start-up firms that enable detailed due diligence, as well as providing post-investment resources, via business angel syndication

² Source: Angel Investing: Matching Startup Funds with Startup Companies -- A Guide for Entrepreneurs, Individual Investors, and Venture Capitalists; By: Mark Van Osnabrugge, Robert J. Robinson; Publisher: Jossey-Bass; First Edition (April 18, 2000)

and venture funds. The key is the existence of efficient exit scenarios when investors and the founding team can realize returns on their investment.

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